Internal Revenue Service

memorandum

CC:TL-N-10280-90
Br1:JCAlbro

date: OCT 16 1990

to: Regional Counsel CC:NA
Attn: Anne O. Hintermeister
Special Trial Attorney

from: Assistant Chief Counsel (Tax Litigation) CC:TL

---

subject: [redacted]
ACRS Losses on Mass Asset Dispositions

This is in response to your request for tax litigation advice concerning a proposed legal position by the Manhattan District to disallow ACRS losses claimed by taxpayer upon the retirement of mass assets.

ISSUE

Whether the Service should follow its position in proposed regulations that proceeds from dispositions of assets from mass asset accounts are included as ordinary income in light of litigation hazards which exist in this case. [redacted]

CONCLUSION

The litigation hazards for disallowing mass asset losses are substantial. In light of the statute, regulations, legislative history and case law, we believe that taxpayer has credible arguments that such losses are allowable.

FACTS

The taxpayer's subsidiaries have claimed losses on property for the [redacted] through [redacted] taxable years. These losses were identified on the tax returns as recovery property retirements or dispositions under ordinary gains and losses. The identity of the assets and the nature of the dispositions was not disclosed. The ACRS losses claimed on the [redacted] through [redacted] returns consist of asset retirements, either to a scrap account or a material and supplies account, and abandonments. Total ACRS net losses claimed by the taxpayer amount to approximately $[redacted], of which $[redacted] was attributable to mass assets.

The taxpayer has three types of asset accounts in its accounting system: (1) actual cost accounts where the original

cost of the asset is placed in the account when the asset is placed in service; (2) uniform cost accounts where the assets are placed in service using a uniform average cost; and (3) computed mortality accounts or mass asset accounts where both the cost of the assets and the year in which they were placed in service is unknown. The taxpayer uses mathematical formulas to compute losses from retirements in all of these accounts, including the mass asset accounts. The taxpayer contends and has attempted to demonstrate that although losses are computed by formulas, it has engineering records available whereby it can determine the identity and disposition of individual items.

The taxpayer did not include any statement in its return either electing mass asset accounting or electing to include in income the proceeds from disposing of mass assets, except for an election to include proceeds in income made by the [redacted] subsidiary for two of its mass asset accounts. However, it is apparent from the manner in which the taxpayer computed the losses and the investment credit recapture from dispositions of property in these accounts that it was using mass asset accounting principles.

In a tax litigation advice dated July 22, 1988, we addressed the issue whether the Service should take the position that taxpayers, who are using mass asset accounting principles for ACRS and ITC purposes but have failed to make the explicit mass asset election pursuant to Prop. Treas. Reg. §1.168-5(e), in order to avoid the mass asset election provision for ordinary income recognition upon disposition in lieu of recognizing gain or loss, should be estopped from arguing that they have not made the mass asset election. The TLA presented a primary and an alternative argument to support Service position as set out in background Treasury policy memos (regarding the implementation of the Economic and Recovery Tax Act of 1981) and as set out in the proposed regulations for section 168. Your draft memorandum to the Manhattan District Director notes that the proposed disallowance of the ACRS losses is based upon a memorandum from the Utilities ISP Specialist and that the [redacted] examination teams and the regional holding companies examination teams have differences of opinion on the issue. Because the issue affects both [redacted] and the regional holding companies, a coordinated position is imperative. The current cycle of the [redacted] examination will be closing at the end of this year, and a coordinated position is needed before the case is closed.

DISCUSSION

The basic issue, of course, involves a conflict between one reasonable interpretation of the statute and Service position as set forth in the proposed regulations. Our earlier

advice analyzed alternative litigation positions to support the proposed regulations. That is, proposed regulations make ordinary income recognition mandatory once a taxpayer uses mass asset accounting; whereas, the ordinary income recognition requirement is arguably an election in one way of interpreting the statute. The proposed regulations take the position that taxpayers cannot use mass asset accounting and take gains or losses. Upon further consideration of this issue, we agree with your opinion that such a position has substantial litigation hazards. We would have to convince a court that losses cannot be claimed on disposition of mass assets under ACRS while, for the years at issue, neither the statute nor the legislative history explicitly supports such a position. See, e.g., S. Rep. No. 97-144, 97th Cong., 1st Sess. 52(1981) (a special rule is provided to avoid calculation of gain on the disposition of assets from mass asset accounts.)

I.R.C. §168(d)(2)(A) provides that "in lieu of recognizing gain or loss under this chapter, a taxpayer who maintains one or more mass asset accounts of recovery property may, under Regulations prescribed by the Secretary, elect to include in income all proceeds realized on the disposition of such property." Prop. Treas. Reg. §1.168-5(e) sets out the manner of making the election. Prop. Treas. Reg. §1.168-2(h)(1) provides that "a taxpayer may elect to account for mass assets...in the same mass asset account, as though such assets were a single asset....if such treatment is elected, the taxpayer, upon disposition of an asset in the account, shall include as ordinary income...all proceeds realized to the extent of the unadjusted basis in the account...." Temporary regulations were issued in 1981 and Temp. Reg. § 5c.0(a)(1) refers to the section 168(d)(2)(A) election as "inclusion in income of proceeds of disposition." In summary, a mass asset election is not provided for in the Code or the temporary regulations. The mass asset election in the proposed regulations is not legally binding on taxpayers. As we stated in the July, 1988 TLA, there is also no requirement for a mass asset accounting election in the ITC regulations. Furthermore, under pre-ACRS regulations, taxpayers were allowed to claim losses from mass asset accounts by using mortality dispersion tables. Treas. Reg. § 1.167-11(d)(3)(v)(d).

The proposed regulations thus appear to take a different position than section 168(d)(2)(A) which provides an exception or an elective choice to recognizing gains and losses. Our hazards in defending the proposed regulations are great because courts give little weight to proposed regulations. See, e.g., Laglia v. Commissioner, 88 T.C. 894, 897(1987), AOD CC-1987-019 (Acq. in Result Only); Zinniel v. Commissioner, 89 T.C. 357, 369 (1987) (Proposed regulations are merely suggestions made for comment and do not have the force of law.) In addition, the Service recently lost a Tax Court case involving

the short taxable year provisions of section 168. The court stated that the proposed regulations, upon which respondent relied, carry no more weight than a position advanced on brief. McKnight v. Commissioner, T.C.Memo. 1990-69.

The Tax Reform Act of 1986 changed the mass asset provisions. Pursuant to new Code section 168(i)(4), if a taxpayer has elected to treat all of the assets of a general asset account as if they were a single asset, all proceeds on any disposition of property in a general asset account shall be included in income as ordinary income. The Senate Finance Committee Report, S. Rep. 99-313, 99th Cong., 2d Sess. 104(1986), regarding TRA 1986, discusses present law and states that the full amount of the proceeds realized on disposition of property from a mass asset account are to be treated as ordinary income. See also Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1986, 99th Cong., 2d Sess. at 108 (1987). It appears, though, that the reports are referring to the proposed regulations in discussing "present law" because the mass asset election provisions referred to are only defined in proposed regulations. The reports characterize the treatment of mass asset dispositions under MACRS as a continuation of present law. Yet, there is a material change in the language of the statute; the new language states that dispositions from general asset accounts (called mass asset accounts pre-TRA 1986) result in ordinary income and clearly provides that the election is an election to treat assets in a general asset account as though they were a single asset. Thus, the new statutory language follows the rule set out in the proposed regulations and provides the argument for taxpayers that the rule was different under the previous statutory language.

We have coordinated with Technical, and they agree with our analysis of the litigating hazards. They also offered several suggestions on evaluating how taxpayers are using mass asset accounts.

First, it appears that taxpayers may be including property placed in service in different years in the same mass asset account. The Service has always required mass asset accounts to be vintage accounts, not open-ended accounts. A similar issue to explore is whether depreciation deductions have been claimed on property placed in service and disposed of in the same year. Section 168(h)(2)(B) disallows a depreciation deduction in the year in which property is disposed.

Technical also suggests evaluating whether taxpayer computed ITC recapture correctly, and whether taxpayer's depreciation deductions under its mass asset accounts were different than those allowed under section 168(b) which provides, "except as otherwise provided in this section, the amount of the deduction

allowable... for any taxable year... shall be... determined in accordance with the following table...."

If you have any further questions, please contact Joyce C. Albro at 566-3442.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch 1
Tax Litigation Division